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Are Surety Agreements Insurance? Federal Courts Weigh in

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When is insurance not insurance? According to both Merriam-Webster and Black's Law Dictionary, insurance is a "contract whereby one party undertakes to indemnify or guarantee another against loss by a specified contingency or peril." Under that definition, "insurance" would include surety agreements, where one party agrees to indemnify another party if a third party defaults on a debt or fails to perform on a contract. But not so fast. A recent Pennsylvania federal court decision dismissed a bad-faith claim against a surety, finding that a surety bond is not "insurance" in *Upper Pottsgrove Township v. International Fidelity Insurance*, No. 13-1758 (E.D.Pa. Oct. 2, 2013).

Last month, U.S. District Judge Stewart Dalzell of the Eastern District of Pennsylvania had to decide whether a surety bond was "insurance." The case involved an alleged bad-faith refusal by the surety to honor its contract. Upper Pottsgrove Township had engaged a contractor to do work. When the contractor originally agreed to the work in 2006, the township required it to escrow nearly $2.5 million to secure its performance on the project. But, in 2008, the contractor was allowed to substitute a surety bond issued by International Fidelity Insurance Co. (IFIC). A year later, the contractor declared bankruptcy and stopped working on the project. The township looked to the surety to pay on the bond. When IFIC refused, the township started an action for breach of contract and bad faith under Pennsylvania law.

Under Pennsylvania law, frivolous or unfounded refusals to pay insurance may constitute bad faith. However, Pennsylvania's bad-faith statute, 42 Pa.C.S. § 8371, applies only to actions "arising under an insurance policy." Working carefully through the arguments on each side, Dalzell dismissed the township's bad-faith claim, predicting that the Pennsylvania Supreme Court would conclude that sureties are not "insurance" under the statute.

In distinguishing a surety from an insurer, Dalzell focused on the contractual relationship that arises in each situation. The court acknowledged that the two are similar in some respects. However, Dalzell characterized an insurance policy as a bilateral agreement requiring the insurer to pay money to the insured for the death, destruction, loss or injury of someone or something. In contrast, he wrote, a surety contract creates a tripartite relationship, where the surety agrees to answer to the beneficiary (the "secured party") for the debt or default of the obligor. In addition, surety involves two contracts—the underlying performance contract and the surety bond—not just one, as is true of the typical insurance situation.

Dalzell rests his analysis on treatises and several prior federal cases that distinguish insurance from surety bonds. Those sources, however, do not address whether it is sound public policy to recognize that

distinction in the context of bad-faith claims. Nor do they discuss how to account for life insurance contracts, which, like a surety bond, also create a tripartite relationship—among the insured, insurer and beneficiary. Reviewing the landscape of federal cases and the bad-faith statute itself, Dalzell concluded as a matter of statutory interpretation that a surety contract is not an "insurance policy" for purposes of Pennsylvania's bad-faith statute.

The issue, however, is far from settled in the U.S. Court of Appeals for the Third Circuit. The Third Circuit has not addressed the issue. Moreover, at the state level, neither the Pennsylvania Superior Court nor the Supreme Court has opined on the matter. Even the Pennsylvania statutes give ambiguous guidance, for Pennsylvania's Unfair Insurance Practices Act specifically includes "suretyship" in its definition of "insurance policy." Moreover, although the *Pottsgrove* decision is consistent with the majority of recent decisions, earlier Pennsylvania district courts had applied Pennsylvania's bad-faith statute to surety bonds. For example, in *Reading Tube v. Employers Insurance of Wausau*, 944 F. Supp. 398, 403 (E.D.Pa. 1996), U.S. District Judge J. Curtis Joyner denied the surety's motion for summary judgment on a bad-faith claim, observing that Pennsylvania courts "have extended this statute to actions against sureties for failure to honor performance bonds."

The issue is similarly unsettled in New Jersey, where bad-faith law has evolved from the common law rather than statute. In 2000, U.S. District Judge Joseph Irenas of the District of New Jersey predicted that New Jersey would recognize a bad-faith claim against sureties in *Don Siegel Construction v. Atul Construction*, 85 F. Supp. 2d 414 (D.N.J. 2000). Although he recognized that surety and insurance relationships are not identical, he found them to be "closely analogous" for the purposes of bad-faith claims. He also found that the public policy underlying bad-faith claims against insurers—to discourage grossly improper claims handling and denials—was equally applicable to sureties. According to Irenas, the "paramount purpose of a surety agreement is to protect the obligee in the event of the principal's default." As with an insurance contract, that "purpose would be contravened if a surety could refuse to respond to a legitimate claim in a timely fashion and incur liability solely for the amount of the bond plus interest."

In 2011, however, then-U.S. District Chief Judge Garrett Brown Jr. disagreed with Irenas and held that New Jersey law would likely not recognize a bad-faith claim based on a surety in *Deluxe Building Systems v. Constructamax*, No. 06-2966, (D.N.J. Jan. 31, 2011). Rather than focus on the relationship between the parties or the purpose of bad-faith claims, Brown based his prediction on the longstanding failure of the New Jersey state courts to recognize explicitly a bad-faith claim in the surety context. He wrote that the inactivity of the state courts in this area of the law suggested that New Jersey does not recognize bad-faith claims against sureties. Notably, however, Brown's opinion does not cite any state court decision upholding his view or any case presenting the issue for review by the New Jersey state courts.

The question of whether a beneficiary can bring a bad-faith claim based on a surety agreement is therefore unsettled in both Pennsylvania and New Jersey. Further, the conflicting decisions on the issue have been written almost entirely by federal courts, which are limited to predicting how state courts would rule on the issue. These predictions are difficult for federal courts, and (as Dalzell conceded in his opinion) they have often been proven incorrect by later state court decisions. Adding to the uncertainty is the absence of any decision on the issue by the Third Circuit. Simply put, as it currently stands, there is no binding precedent for New Jersey or Pennsylvania federal trial courts that addresses whether a bad-faith claim is viable against a surety.

What is the rule outside the Third Circuit? Although there is disagreement among the states, the majority recognize bad-faith claims based upon surety agreements. However, across the country, the issue is decided differently depending on state statutes, public policy and case law.

The present uncertainty in the law has important implications for both attorneys and businesses. Had Upper Pottsgrove Township known in 2008 that the contractor's bankruptcy could lead to a lengthy dispute with the surety that would carry significant litigation costs and leave its development project in

limbo, it may not have permitted the contractor to substitute a surety bond for escrowed cash. Also, the unsettled state of the law makes it prudent to include a choice-of-law provision that calls for the application of the law of a state where this question is well settled.

Whether a claimant under a surety contract may bring a bad-faith claim can, of course, substantially affect the value of its claim. Uncertainty about whether such a claim is viable impairs the parties' ability to resolve a dispute without resorting to lengthy litigation. The interests of both judicial and commercial efficiency would be well served if the state courts in Pennsylvania and New Jersey could resolve the issue. Is surety a form of insurance, or is it not? It is surprising, and unfortunate, that the federal courts must speculate about the direction of state law every time this issue arises.

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